No. 88-2133

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1989

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

GEORGE PRUSSIN AND SHARON PRUSSIN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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1. In our petition, we urge that certiorari is warranted because the court of appeals has erroneously decided a recurring issue of importance to the administration of the tax laws in a manner that conflicts with decisions of three other courts of appeals. Specifically, we argue that the decision below conflicts with *Estate of Isaacson* v. *Commissioner*, 860 F.2d 55 (2d Cir. 1988); *Odend'hal* v. *Commissioner*, 748 F.2d 908 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985); and *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976).

Respondents do not, and cannot, dispute that the decision below conflicts with the Second Circuit's decision in *Estate of Isaacson* (see Br. in Opp. 4-5). As we explain in our petition (at 14-15), that case involved another investor in the same tax shelter at issue here, and the cases were consolidated in the Tax Court. That investor was represented by the same counsel as respondents and made the same arguments to the court of appeals. The Second Circuit affirmed the judgment below in its entirety for the reasons stated by the Tax Court (see 860 F.2d at 56-57), which had rejected the investors' argument that they should be allowed deductions based on the fair market value of the property (Pet. App. 58a-59a). The reality and authoritativeness of the Second Circuit's decision are not diminished by respondents' cavil (Br. in Opp. 5) that these courts, in rejecting an argument that was flatly inconsistent with the results in other court of appeals decisions and that had never been accepted by any other court, did not sufficiently explain their reasoning. Conversely, the court below, on identical facts, reversed the decision of the Tax Court in part and remanded the case for the allowance of such deductions. Thus, as the court of appeals below acknowledged (Pet. App. 3a n.2), the results of the two decisions are irreconcilable. The existence of this square conflict between the Third and Second Circuits is alone sufficient reason for this Court to grant certiorari on this important issue.

Moreover, respondents' efforts to distinguish the other two court of appeals decisions cited in our petition are unavailing. As we explain in our petition (at 16-17), the Fourth Circuit in *Odend'hal* held that the taxpayers could not take interest and depreciation deductions based upon nonrecourse obligations

that substantially exceeded the fair market value of the collateral because they were not genuine indebtedness. The court clearly did not allow the taxpayers to take deductions for the portion of the nonrecourse obligation that did not exceed fair market value; the passages quoted by respondents (Br. in Opp. 5-6), read in context, do not seek to justify such deductions but rather explain why greatly inflated levels of nonrecourse debt are not genuine indebtedness—namely, because the disparity between the amount of the obligation and the fair market value of the collateral eliminates any economic incentive for the debtor to pay. Nor can *Odend'hal* be reconciled with the decision below by virtue of the allowance there of deductions up to the amount of the income from the property (see Br. in Opp. 5). Allowing deductions against actual income is an entirely different matter from the substantial tax shelter that respondents seek here on the basis of a hypothetical obligation in the amount of the fair market value of the property; indeed, the Commissioner did not contest the right to take deductions up to the amount of income from the property either in *Odend'hal* or in this case.

The Ninth Circuit in *Estate of Franklin* also clearly held that no deductions may be taken for nonrecourse obligations that substantially exceed the fair market value of the collateral. The court concluded (544 F.2d at 1049): "For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price." This rule leaves no room for the partial deduction approach espoused by the court below. While, as respondents note (Br. in Opp. 8), the

court in *Estate of Franklin* stated that the taxpayer had failed to prove the fair market value of the property, the decision to deny all deductions in that case plainly was not premised on an (almost certainly false) assumption that the property had no value. Rather, the court of appeals was quite specific in identifying the fatal failure of proof—namely, failure to demonstrate that "the purchase price was at least approximately equivalent to the fair market value of the property" (544 F.2d at 1048; see also *id.* at 1048 n.4). The holding of *Estate of Franklin* is that, in the absence of such approximate equivalence, the taxpayer cannot take deductions based on the nonrecourse obligation. That holding is inconsistent with that of the court of appeals here.

2. Nor are respondents correct in contending (Br. in Opp. 6 n.4) that Section 1274(b)(3) of the Internal Revenue Code (26 U.S.C.), and the regulations thereunder, support the approach of the court below. That Section is addressed to an entirely different situation from that presented here and in no way suggests that a taxpayer should be entitled to take deductions based on a nonrecourse obligation that greatly exceeds the fair market value of the collateral. Section 1274, which was added by Section 41(a) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 538-539, was designed to prevent taxpayers from obtaining unwarranted tax advantages by characterizing what is actually interest in a deferred payment transaction as principal. See H.R. Rep. No. 432, 98th Cong., 2d Sess. Pt. 2, at 1244-1245 (1984). The "potentially abusive situation" (§ 1274(b)(3)) addressed by the new statute includes a case where the purchaser pays a total consideration on a deferred basis that conforms to the

fair market value of the property (discounted to present value), but where the transaction is structured (by stating a below market interest rate) so that the stated purchase price of the property exceeds its current fair market value. See H.R. Rep. No. 432, *supra*, at 1244 n.10.

In sum, the issue in this case concerns the tax treatment of a nonrecourse obligation that is inflated well beyond fair market value and hence reflects neither genuine indebtedness nor real consideration that is truly intended to be paid for the property. Section 1274, conversely, is addressed to the situation where the debt instrument does reflect consideration that is actually being paid for the property, in conformity with its fair market value, but where the instrument has made an unrealistic allocation of that consideration between interest and principal. Section 1274 operates to allocate those two components correctly. This is clearly illustrated by the simple example given in the House Report. H.R. Rep. No. 432, *supra*, at 1244 n.10.* Thus, Section 1274

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* The more complicated examples cited by respondent from proposed regulations under Section 1274 (proposed on April 8, 1986, 51 Fed. Reg. 12,022, but not yet adopted in final form) similarly reflect this basic distinction. For instance, in Example (3) of Section 1.1274-3(c)(2) (see 51 Fed. Reg. 12,068 (1986)), there is no suggestion that the total consideration reflected in the debt instrument exceeds the fair market value of the property. In order for this example to illustrate the general rule of Section 1.1274-3(c)(1) for determining whether a debt instrument provides for adequately stated interest, it must contemplate that, in purchasing property worth $7 million for consideration of $1 million in cash and a debt instrument with a stated principal amount of $7 million, the purchaser has not overpaid for the property—*i.e.*, that the total consideration (discounted to present value) is equivalent to the current fair market value of the property,

addresses situations where the purchaser does have an economic incentive to live up to the terms of his bargain, and hence it provides no support for the decision below. Indeed, the Joint Committee's explanation of Section 1274 specifically notes that Congress did not intend to endorse partial recognition of the nonrecourse debt issued in abusive tax shelter schemes such as the one in this case. The Joint Committee explained:

> The limitations on principal amount imposed by these provisions do not override prior case law dealing with overstatement of basis and other abuses in transactions involving nonrecourse debt. As under prior law, an obligation must represent a bona fide indebtedness of the purchaser-issuer to be respected for purposes of the [original issue discount] rules and other provisions of the Code. Thus, if a nonrecourse obligation is given in exchange for property having a value less than the principal amount of the purported debt obligation * * *, the obligation may be disregarded in whole or in part under general principles of tax law and basis, interest deductions, and other tax benefits may be denied. *See, e.g. Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976); *Odend'hal* v. *Commissioner*, 80 T.C. 588 (1983); Rev. Rul. 78-29, 1978-1 C.B. 62; and Rev. Rul. 82-224, 1982-2 C.B. 5.

Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions*

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but that the stated principal amount of the note has been inflated by understating the true interest rate. Accordingly, Section 1274 comes into play to restructure the note to provide for a $6 million principal amount at a market interest rate.

of the Deficit Reduction Act of 1984, at 119 (Joint Comm. Print 1984).

3. Respondents' suggestion (Br. in Opp. 13) that this case potentially presents a constitutional question is entirely without merit. It is well settled that tax deductions are a matter of legislative grace. See, *e.g.*, *Deputy* v. *du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934). Thus, if the Internal Revenue Code does not permit respondents to take a deduction based upon nonrecourse debt that greatly exceeds the fair market value of the collateral, that is the end of the matter; there surely is no "taking without due process" (Br. in Opp. 13). Moreover, as we explain in our petition, the denial of all depreciation and interest deductions attributable to such inflated nonrecourse indebtedness is not a penalty, but rather reflects the absence of any financial incentive on the part of the borrower, who is not personally liable, to pay. Thus, respondents' nonrecourse obligation was not genuine indebtedness and did not represent a true investment in the property; therefore, neither common sense, the Internal Revenue Code, nor any constitutional principle suggests that they should be entitled to base interest and depreciation deductions upon that nonrecourse obligation.

For the foregoing reasons, and those stated in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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